Nexus Notes

June 2020
Vol. 25, No. 2

Featuring:

Invest *Thoughtfully*™

NEXUS

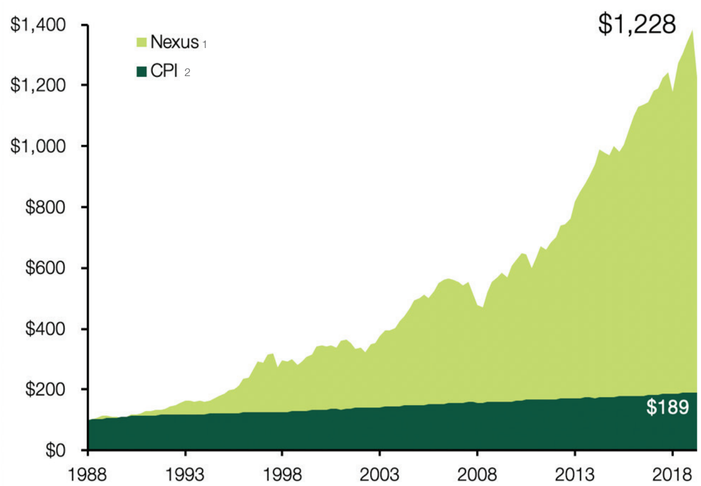
Our market-resilient investment strategy focuses on long-term results, providing investors with peace of mind through all stages of life.

Building Value for Clients

Since its establishment in 1988, Nexus has pursued an investment approach which concentrates on real growth in client wealth over the long term.

The chart illustrates the impact of this long-term investment thinking – a $100 investment in a balanced portfolio in 1989 has grown to $1,228 at March 31, 2020.

$100 Investment with Nexus in 1989



NEXUS

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1 "Nexus" reflects the performance of a composite of Nexus accounts managed to a balanced mandate (until September 30,1997) and the Nexus North American Balanced Fund (thereafter). Returns shown prior to the deduction of investment management fees.

2 CPI is the “all-items” Consumer Price Index for Canada, not seasonally adjusted.

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In this issue:

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FROM THE EDITOR

Pivot

In this time of COVID-19, change is underway. Working from home, wearing masks and hoarding a lifetime's supply of disinfectant wipes are just a few examples of our new personal reality. COVID-19 is also changing business reality. The Business Roundtable, which is a group of 181 CEOs, made a pivot when they issued a statement about the purpose of corporations shifting from shareholder capitalism to stakeholder capitalism.[1] But what does this mean?

For many decades the purpose of corporations has remained the same: serve shareholders, primarily by maximizing profits and share prices. Now, the Business Roundtable CEOs are suggesting that corporations need to commit to serving not only shareholders, but customers, employees, suppliers and the public at large. According to Alex Gorskey, chairman of the Business Roundtable and CEO of Johnson & Johnson, this pivot "affirms the essential role corporations can play in improving our society when CEOs are truly committed to meeting the needs of all stakeholders… if companies fail to recognize that the success of our system is dependent on inclusive long-term growth, many will raise legitimate questions about the role of large employers in our society."[2] In a system of stakeholder capitalism, corporations strive to promote long-term societal welfare.

As it turns out, these considerations are included in the social responsibility element of "ESG". ESG stands for three criteria on which any company can be evaluated: environmental compliance and stewardship (E), social responsibility (S), and corporate governance (G). Many clients have asked how Nexus incorporates ESG into its investment process. You may be surprised to discover that these pillars have always been considerations in our investment philosophy. In this issue of *Nexus Notes*, you will find an article written by John Stevenson about how we integrate ESG into our investment process, and also how COVID-19 is changing how investors think about ESG.

Nexus has also faced a shift when it comes to how we do business since COVID-19 has arrived. We have made a myriad of changes to ensure things run smoothly while we are working from home. You can read about these in the article *Swimming Naked* by Denys Calvin. It is of utmost importance to continue to connect with clients, as always. Zoom is a good solution for client meetings. We can share investment reviews and financial plans one-on-one with clients online, thanks to Alex Jemetz, who introduced us to the Zoom application last year. We are also hosting our group investment reviews in the form of a live webinar with a Q&A. Nicole Weiss, our marketing manager, made a tremendous effort to ensure this works smoothly. While we miss the personal interaction, and we can't provide lunch, we will continue to offer these forms of interaction. If you missed our live session in May, a recording of the full webinar is on our website, along with a shortened version.

Finally, in this issue we have a tax planning article for you to ponder. With change comes opportunity, so, with interest rates dropping, the prescribed rate loan strategy is back in favour. Read about this income splitting strategy in an article written by Nexus financial planner and CPA, Brad Weber. To close, we hope everyone is able to enjoy the wonderful summer weather. Borrowing the words from Dr. Bonnie Henry, who has successfully led British Columbia through its coronavirus fight: be kind, be calm, be safe.

Dianne White
CPA, CA, CFP, TEP

[1,2] Joy Thomas, "The New Bottom Line", *Pivot CPA Canada*, March/April 2020.

INVESTMENTS

COVID-19 Has Highlighted the "S" in ESG

John C.A. Stevenson
CFA

"ESG" has become a powerful three-letter "word" in the investment world in recent years. The letters stand for three criteria on which any company can be evaluated: environmental compliance and stewardship, social responsibility, and corporate governance.

These criteria are quickly becoming important lenses through which investment decision making occurs, both because failure to act responsibly in any of these areas can present real financial risk, but also because excelling in these areas can positively differentiate a company from its peers.

In the "old days", socially responsible investing usually involved negative screens. Don't buy tobacco or alcohol stocks. Don't buy gambling stocks. Don't buy the stocks of companies that make land mines that can kill unsuspecting children playing in a field. In my university days, I can vividly remember the protests to demand that Harvard divest from companies in South Africa during the Apartheid era. These are all rules that reduce the opportunity set for investors. Of course, whenever the opportunity set is reduced, there is a cost of lower expected returns. The challenge was that the cost was unquantifiable and the rules themselves often hard to define.

Today, the emphasis in the investing world has shifted such that many investors, Nexus included, consider ESG factors in a positive way. Companies that are leaders in these areas often are more successful than their peers. Strong ESG performance, theoretically, can lead to higher investment returns, not lower returns, which is the theoretical consequence of negative screens.

Many investment firms integrate ESG analysis into their investment process. ESG evaluation becomes one of the criteria, along with competitive analysis, valuation analysis, management interviews, etc. Importantly, ESG integration does not preclude any investment the way a negative screen does. It simply tries to ensure that all the investment risks are fully considered. An energy company, by definition, faces significant environmental risks. It's the nature of its business that it cannot avoid. But some companies will manage this risk better than others. ESG integration supports investment in such a company, but only after an investor is satisfied the company is managing the risks effectively.

Nexus's investment process integrates ESG factors just as described above. We subscribe to ESG analysis from an organization called Sustainalytics, which is one of the two big ESG research providers in North America. Sustainalytics has 250 analysts covering 11,000 companies around the world. We have found its research to be extremely useful as it provides a different perspective on companies than traditional investment research. Having said that, ESG has always been part of the Nexus investment process, we just didn't use the current vocabulary. If you are serious about making long-term investments, it matters that a company operates in a sustainable way. Today's ESG considerations provide a more detailed and comprehensive template for analysis. It is an evolution rather than a revolution.

This somewhat drawn out background brings me to the title of this essay. COVID-19 has affected how investors think about ESG. Before the pandemic, there is no doubt environmental issues were consuming the vast majority of attention related to ESG. You can't pick up a newspaper without reading, usually on the front page, an article about climate change and how companies and governments are addressing it… or not. There always has been a focus on corporate governance. It matters that boards are independent, and it matters that shareholders voices are heard. We have occasionally voted our proxies against management and in favour of greater shareholder democracy where it seemed appropriate. Until recently, however, the "S" in ESG was often given short shrift. COVID-19, however, has provided social considerations their moment in the sun.

The "social responsibility" element of ESG considers how a company treats its various stakeholders, such as employees, suppliers,

customers, and local communities. Considerations like diversity, human rights and consumer protection are at the centre of it. Using child labour to manufacture products in a sweat shop is a situation that would be deeply disturbing. But social responsibility also addresses the general question: is a company being a good corporate citizen? These issues are critically important but have been over-shadowed in recent years by the climate change discussion. Never have investors been more interested in how a company is treating its employees, customers and suppliers as during this health crisis. Moreover, we think that the reputation companies build in the crisis could well become a competitive advantage that is enduring.

George Weston is the most recent stock we have added to our investment portfolios. Within George Weston, the biggest business is Loblaw. The accelerated roll-out of its "PC Express" service, which facilitates customers' contact-less click-and-collect grocery purchases, has established Loblaw as the leader in online grocery in Canada. Moreover, Loblaw chose to waive the fee it normally charges for the service to help families in this difficult time. It has also made substantial efforts to ensure the safety of its essential frontline employees. We think Loblaw will benefit greatly from customer loyalty and its first mover advantage long after the health risk has subsided.

Similarly, another Nexus holding, TELUS, has announced it will voluntarily extend payment terms for customers in financial distress, put a moratorium on disconnections while the crisis persists, waive any data overage charges for internet customers working from home, and waive roaming charges for a large segment of its customer base. These are all measures which help TELUS's customers today. However, we think TELUS will be well-rewarded over time with the economic benefits that come from increased customer loyalty.

Quite frankly, we have always thought that the "social" aspect of ESG didn't get as much attention as it deserves. While we certainly wish that COVID-19 never existed, a greater focus on corporate social responsibility is a positive by-product of this crisis that we hope becomes permanent.

A Tax Planning Strategy
That Still Works – *and Is Getting Better*

Brad Weber
CFA, CA, CFP

When it comes to strategies that help you save tax, good news has been in short supply these past few years. That will change beginning July 1st, 2020, when the prescribed rate of interest will drop from the current rate of 2% down to 1%. This interest rate applies when lending to family members for income splitting; the lower the interest rate, the better the potential for tax savings.

What is Income Splitting?

Income splitting is a strategy to reduce a family's overall tax bill by transferring income from a high-income earner to a low-income earner. Splitting income with family members is complicated because of a set of regulations called Attribution Rules, which are designed to prevent this type of income shifting except in certain circumstances. The Attribution Rules are complex and beyond the scope of this article. But, if you follow the rules, and your situation warrants it, it is possible to achieve income splitting with a Prescribed Rate Loan strategy.

How Does a Prescribed Rate Loan Strategy Work?

Consider, for example, a couple with one individual in a high tax bracket, and the other in a low tax bracket. Further consider that there is a non-registered investment portfolio or cash available for investing. Typically, the high-income earner would be the source of savings for the investment portfolio, and the investment income earned would be traced back to the high-income earner and taxed in their hands at a high rate. The question becomes, how can you shift the investment income to be taxed in the hands of the lower-income earner? You can't simply gift the investment portfolio to the lower-income spouse, as the Attribution Rules will prevent tax from being saved in this manner. However, if the high-income earner lends that money to the lower-income spouse, to be invested in their hands, and charges loan interest at the prescribed rate, the couple could have the investment income taxed at lower rates.

It's important to understand that interest from the loan must be paid by the borrower and declared on the high-income lender's tax return. The strategy shifts the excess of investment portfolio returns over the prescribed rate of interest into the lower-income spouse's hands. Consequently, the lower the prescribed rate of interest, the more potential investment income that can be shifted to the lower-income spouse, and the greater the potential for tax savings.

Impact on Existing Prescribed Rate Loans

One of the features of this strategy is that the interest rate is locked in. This means the prescribed interest rate in effect at the time the loan is created will be unchanged over the lifetime of that loan. Any prescribed rate loan established when the interest rate was 2% will continue to stay at that rate even after July 1st, when the rate drops. It is possible to take advantage of the lower rate, but it would mean repaying the existing loan and reissuing a brand new loan at the lower rate. Most likely the current investment portfolio would need to be liquidated to generate the cash necessary to repay the loan. This liquidation might trigger capital gains; therefore, any estimated taxes should be evaluated against the potential benefits of making this change. It's possible that recent market declines might eliminate this concern. But, that could result in another problem. If the portfolio value has fallen below the original loan value, there might not be enough cash to repay the current loan. Whatever the situation, you need to take careful consideration if you are looking to change an existing loan.

With the prescribed interest rate falling in July, now is an opportune time to consider potential benefits from an income splitting strategy. If you have cash that you are thinking about investing, this might be a way to do it more tax efficiently. As with all tax matters, things are more complicated than can be described in a few short paragraphs, so don't rush out until you've consulted with your financial advisors.

Swimming Naked

R. Denys Calvin
CFA

Warren Buffett has a wonderful line. "Only when the tide goes out do you discover who's been swimming naked." He uses it in an investment context to refer to businesses that aren't all they appear to be, and how the revelation of their shortcomings is inevitable when times get tough.

But the expression has application more broadly. It has been running through my mind off and on the last 8 weeks as we at Nexus have been figuring out how to operate in a "shelter-in-place" world. My variation of Buffett's line goes something like this. "Only when you can't be in the office together do you realize the things that won't work unless you're in the office together." Each realization is usually prefaced with something like "Oh. Yeah. I guess that's right. That won't work so well…" Suffice it to say that that utterance has been heard rather a lot lately.

Fortunately, this isn't a tale of drama and close calls. In fact, things are working remarkably well. We're in touch with clients at least as often as before, if not in person. Investment decisions are getting made and portfolios are receiving all the attention they deserve and need at times like these. Even our usual quarterly reporting to clients went into the mail and onto our portal right on time last month.

Most of us have been working from home since mid-March. On any given day, only those who want, or feel they need, to be in the office are there – between two and four Nexus people. Mercifully, as an "essential business" in the eyes of the Ontario Government, we and other portfolio managers are not completely shut out of our office.

While there are some things – like mail, deliveries and producing printed materials – that simply can't be handled from home, it is extraordinary how much can be accomplished with a combination of software, the Internet, and a little ingenuity.

All the tools we use in the office day-to-day are available to each of us through a high-security, remote access arrangement we've had in place for years. For sure it is getting a much bigger workout than ever before. And we've had to add capacity to it a couple of times to accommodate the demands of 15 people using it all day, not just one or two occasionally after hours. But each person, using whatever computer or laptop they have at home, can do all the same things there as they can in the office, without any sensitive firm or client information having to escape the confines of that secure environment.

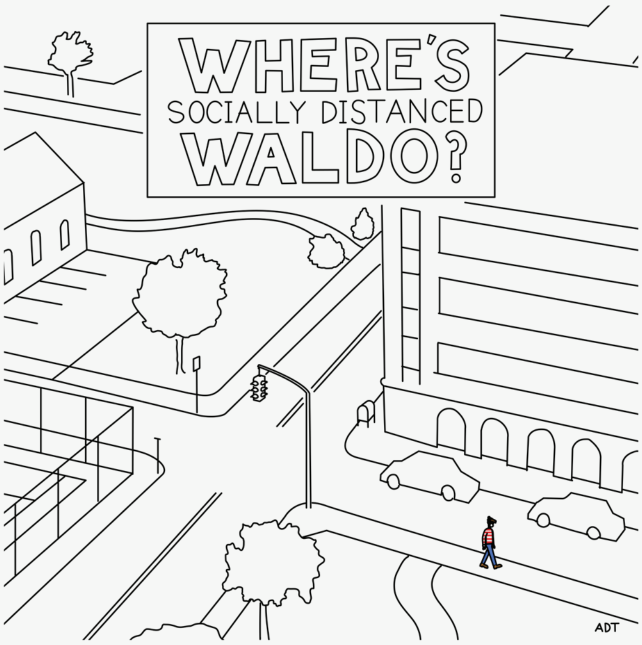
As implied by my fondness for the Buffett quote, however, we've had to make a myriad of changes to have any hope of doing things as smoothly as we would in the office. Some of these are easy to describe. We had to forward everyone's office phone to their cellphone so calls to the office wouldn't get relegated entirely to voicemail. Procedures that depended on a piece of paper circulating from desk to desk in the office have been converted to some sort of electronic/email process. And we had to scramble to make arrangements with one supplier so their sophisticated research and trading tool that the investment team shares on a single physical device in the office could be accessed remotely.

Other things are a little trickier and have required some quick, interesting workarounds. When you pay suppliers by cheque, and it takes two to sign, you know a courier is going to be involved at a couple of stages. We can't email something to a client for their signature if they don't have email. Even if they have email, but don't have a printer, we need to be able to handle that.

These are just our processes. Our suppliers aren't standing still. They, too, are making changes that we've had to respond to. The most significant was our custodian's announcement late one Sunday night at the end of March that they would no longer accept cheques from clients who wanted to add money to their Nexus accounts. In less than two weeks we modified our processes and systems so we can now "pull" funds from a client's bank account electronically.

Many of the adjustments we've had to make will be permanent. They're simply a better way of doing things than before. And for as long as we have to operate while practicing "social distancing", we're optimistic we'll be able to do all the things clients count on us for. But we're also rooting for the pharmaceutical and scientific communities to find a vaccine for this plague soon so we have the option of going back to the in-person exchanges and collaboration that make our business so stimulating and rewarding.

Worth 1,000 Words...



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